

# Where are post-communist countries heading to?\*

by  
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## Introduction

What a difference as compared to the early nineties, which were judged through the fervour and the intellectual lenses of Fukuyama's end of history famous article and book. In a fundamental sense the author was right: 1989 marked a watershed in history, signalling the decisive demise of communism. In another sense, his analysis was simplifying and obscuring resilient forces at work in history, those which maintain ideological and religious differences; forces which, when uncurbed by democracy (checks and balances) and mutual tolerance, can lead to huge human suffering, such as inter-ethnic conflicts and wars.

Transition proves to be a much more complex and complicated process than initially thought about. Price liberalization, stabilization, privatization are essential for achieving a market economy but far from securing success unless proper institutions are put in place. And this is the biggest challenge for post-communist countries: how to enhance institutional build up when this is a time consuming process, and, at the same time, there is a race against time.

At the start, many were, for obvious reasons, tempted to underestimate two major other transitions in the world, which do have an impact on post-communist transformation. One transition is connected with integration in Europe and the advent of the Monetary Union, with its myriad of consequences. Incidentally, the creation of the Community in 1957 (The Treaty of Rome) was meant to help liberal democracies deal with the threat of communism. Nowadays, the further integration of the EU is intertwined with attempts to reform itself, namely, the welfare state, the CAP, etc; which is a difficult process which bears on *enlargement*. It should be said that, soon after the start of post-communist transition, most of the countries in Central and eastern Europe entered a quest to join the *Club*. For economic, but also security-related reasons, the admission into the EU was set as the overriding strategic choice of foreign and economic policy. Therefore, joining the EU could easily be seen as a final benchmark in the assessment of a successful transformation. Implicitly, a way to compare the performances of post-communist countries is to examine their prospects for accession. The other strategic choice for many post-communist countries was getting into NATO. Whereas this goal was achieved by Hungary, Poland and the Czech republic, for most of the other aspirant countries the road is still remote.

Globalization is another major process in the world economy, which goes beyond the evolution of financial markets and, following the deep crises worldwide, the search for improving the architecture of the international financial system. Globalization should be seen, also, through its impact on social and political structures, the way it fosters both integration and fragmentation, inclusion and exclusion, uncertainty and volatility (bad equilibria)<sup>1</sup>; it does influence the clash

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<sup>1</sup> Such equilibria are enhanced by the diminishing ability of the IMF to act as lender of last resort, the lack of

of ideas as well. In this respect, whereas some declare the definitive victory of markets over governments, others are looking for a way to reconcile the virtues of markets with the need to preserve social cohesion and the ability to pursue public purpose. But, as Larry Summers pointed out at the last ABCDE conference in Washington DD, reconciling the imperative of open markets and the pursuit of public purpose requires, still, much intellectual work and institutional development (1999, p.1).

Global alliances and acquisitions in the banking industry, in oil, car manufacturing, telecommunication, etc., are ushering in a new era in world competition which is intensified by the new information technologies. What one sees in Europe nowadays, in terms of mergers and acquisitions, validates this trend. Could one have foreseen, only some years ago, the way consolidation is proceeding in the dirigist France: with the hostile bid by BNP to take over Societee Generale?

Likewise, the introduction of the Euro, in spite of its recent weakness, symbolizes EU's claims to compete with the US economy and Asian economies. The fight for leadership of the World Trade Organization (which, for the first time, pitted a representative of emerging markets against one of the rich countries) indicates the redistribution of economic power in the world and the new assertiveness of Asia. The Euro may also give a further impetus to the formation of large trading and currency blocs, with the latter being a response to the uncertainty and volatility caused by destabilizing capital movements (let us think about the requests made by several Latin American countries to adopt the US dollar as their national currency). This increased uncertainty gives an additional incentive to the countries of Central and Eastern Europe to join the EU.

In what follows the prospects of post-communist transformation in Central and Eastern Europe are examined according to an inner logic of the process, but also in conjunction with what is going on in Europe as a whole –including dynamics in Russia and in the Balkans. The analysis is not meant to be exhaustive, but to highlight what I see as relevant features and factors of motion during transformation. Likewise, the impact of globalization is considered. The focus is on the exigencies of forwarding market reforms, of empowering citizens, together with the need to perform public policy for the common good. I should commend, in this context, the initiative of the President of the World Bank, James Wolfenson, the so-called Comprehensive Development Framework (CDF), which reflects a deeper understanding of the complexity and ultimate goals of transformation as a modernization (development) process.<sup>2</sup>

## 1. An initial glimpse

There is good and bad news about post-communist transformation in Europe. The good news is that, overall, much has been achieved bearing in mind the burden of the past – or, otherwise said, the current state of affairs could have been substantially worse. A certain kind of *normalcy* has been spreading in the area in terms of the functioning patterns of market-based systems. Even the participation rates in the elections in most countries can be interpreted from such a perspective. This *normalcy* may be partly at the origin of an apparent declining interest Western public opinion and governments show in post-communist transformation. It is true, nonetheless, that this diminishing interest can be linked with the mounting domestic problems of some western European governments and other world developments. However, the notion *normalcy* takes into account what *realists* – as they can be named – have been saying is most likely to

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regulations governing huge movements of capital, and the herd behaviour of investors.

<sup>2</sup> See his interview in *Transition*, this year.

occur, or is achievable under the circumstances. Such realists warned that transformation will be a time-consuming process, that the past weighs heavily in post-communist countries.

Economic recovery has been under way in many countries for years now, and inflation, at least temporarily, has been subdued in many countries. The work of entrepreneurship and the expansion of the private sector proves the enormous economic potential that was stifled by the command system.

Another piece of good news is the way the emerging democratic institutions have been able to vent, the frustration of large segments of the citizenry with the costs of reforms and secured, thereby, a surprising degree of social stability. This fact gives support to those who have argued that history and analogies are not necessarily the best predictor of what is going to happen in Central and Eastern Europe. It is hard not to agree, in this respect, with Valerie Bunce when she remarked early on that 'It is the balance between levels of conflict and systemic capacity to adjudicate conflicts, then, and not simply the degree of conflict which should receive our foremost attention in assessing the stability of the new Eastern Europe' ( p. 281). But it can be contended with similar validity, that it would be a major mistake to consider that post-communist countries are endowed with some specific traits which make them relatively immune to what acute social friction entails in the rest of the world. The probability for big and unpleasant surprises is still considerable, the farther one goes eastwards, where the results of transformation are very mixed, to put it gently. Scenes of acute social disruption occurred in Albania and Bulgaria some years ago and, in most of the CIS countries, authoritarian governments control power. And if one considers, also, size –as in the case of Russia and Ukraine—worries are more than justified.

The bad news, or 'the empty half of the glass' is that, in many post-communist countries the high hopes of quick transition have been disproved; that lots of people in the region have had a very hard time in coping with the psychological pressure and material difficulties caused by transformation.

The geography of transition is very diverse. One can detect clusters, groups of countries which differentiate among themselves as to economic performance and the way institutions do function.

There are frontrunners –Hungary, Poland, the Czech Republic, Slovenia, Slovakia, Estonia; these are followed by the other two Baltic countries. Both these two groups of countries have good prospects to join the EU around the middle of the next decade. It is noteworthy, and I would stress it again and again, that the best performers are in the neighbourhood of the EU. And not accidentally, have highest income per head.

Bulgaria and Romania, which also have Association Agreements with the EU, have had a much more difficult trajectory and their prospects to join the Union are considerably less favorable.

In Russia and Ukraine, and in the rest of the CIS, transition, both politically and economically, is still pretty cloudy. For most of the Balkans area the terms "distress economies" would seem quite appropriate. Tabel 1 illustrates this classification by making reference to growth rates, inflation, the income per capita, etc..

## **2. Understanding transformation: reading the future from the past**

I would argue that the best way to explore the future is to read carefully the past and the present. This is why, next my endeavour is to highlight some lessons of transformation .

### **2.1 The grammar of transition: Complexity is a key word**

**2.1.1** A major lessons of transformation is the need to be open minded, to consider various hypotheses and viewpoints, not to be prisoner of clichés and taboos, of understanding that there can be no perfect blueprints as there cannot be a perfect world. The need of lucidity and pragmatism should compel us to keep our eyes open and confront a reality, which can be overwhelming by its complexity and the magnitude of changes.

-Some years ago, those who were prone to emphasize the *structural nature* of the problems facing post-communist countries made up a minority in the chorus of upbeat voices; they warned about the lack of realism of the theses and conceptions which smelled of the possibility of compressing time at will, of practising a sort of ‘hocus pocus economics’. Now, many analysts reveal a different, significantly more poised stance. A policy should be judged on its own merits by skewing intellectual prejudices.

In this respect, there is need to consider how market economies actually function. As Joseph Stiglitz emphasized, ‘Imperfect and costly information, imperfect capital markets, imperfect competition: these are the realities of market economies – aspects that must be taken into account by those countries embarking on the choice of an economic system’ (1994, p.267).

- the danger of overlooking the extreme complexity of the process under way. Gross oversimplifications and reductionism of the type ‘black vs. white’ (with no shades in-between), and the lack of understanding of how interests are socially articulated – particularly in a transition period – cannot but obscure real processes and lead to hasty and inadequate decisions. G. Schopflin aptly noted, ‘The elite failed to understand that society was a far more complex organism than what they had thought, that simple, well-meaning declarations were not effective in politics, that ideas and programmes would have to be sold to the public, and that institutions were necessary for the routinised exercise of power’ (1994, p. 130).

-An increasing number of professionals emphasize the role of institutions in economic development<sup>3</sup>, the burden of history, and the intensity of what Francois Perroux named ‘emprise de la structure’ (the power of structure), with the latter including the legacy of resource misallocation and the *strain* it entails in the system. Here one can talk about the structural (social) embeddedness of economic phenomena (Marc Granovetter, 1985), which is an approach having as illustrious precursors Max Weber and Emile Durkheim. Such a broad analytical perspective lends to transformation a much richer meaning and content.

-Dealing with the *fine print* of reforms involves much more than simple ideological statements and exhortations; it involves unavoidable pragmatism and making hard policy choices based on solid theoretical and empirical knowledge, when one cannot escape facing painful trade-offs and dilemmas. For instance, one issue that badly needs serious debate is the structure of *corporate governance*; it is ever more clear that one needs to go beyond the general statement regarding the necessity of privatisation

- There is need to place the process into a world-wide context. What I have in mind is Western European countries’s reinforced quest for integration, the crisis of the welfare state, shifting comparative advantages under the impact of the ‘new information age’ and of economic globalisation, etc. I think also of the pressure the globalisation of financial markets imposes on national economic policies, and the related increasing marginal cost of imprudent and inconsistent measures over time. Embeddedness into a wide context helps detect both the expected and the new sources of difficulties encountered by post-communist countries, and what may lie ahead for them.

**2.1.2** There has been an excessive temptation to lump countries together, in various groups, by assuming a pretty much deterministic (mechanical) relationship between preordained results and

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<sup>3</sup> See also Mancur Olson’s superb article in the Journal of Economic Perspectives (1996)

policies implied by a conventional wisdom. As in the old Latin saying ‘post hoc, ergo propter hoc’ close performances were ascribed more to presumed similar policies than to commonalities in initial circumstances, structural factors and policy peculiarities.

It suffices to look carefully at concrete policies among the front-runners to support such a thesis. Poland became the ‘classical example’ of shock therapy regarding price liberalisation, but not privatisation. At the same time, Hungary, in spite of a remarkable policy consistency can be viewed as an example of gradualism, and its economic performances are due also to reforms initiated before 1989. As to the Czech Republic, it applied a big-bang to privatisation...and a sort of heterodox stabilisation policy. Slovenia, because of its favorable initial conditions, applied a sort of gradualistic policy.

In my view, certain traits of politics and social life, of the local (national) industrial and political culture, and other structural factors have strong explanatory power for understanding policymaking. It may be the case that culture and history (the burden of the past), geography and structural factors explain, to a large extent, why certain policies (like macroeconomic stabilisation) were more likely to be undertaken and were more successful in certain countries than in others.

**2.1.3** Instead of being absorbed by preferred clichés and ideal frameworks one should pay more attention to closer-to-reality second-best scenarios --broaden the focus of analysis. This logic would have to apply to both first round as well as n-round (feedback) policy measures. Frequently and with surprising nonchalance, those who pass judgement or provide advice equate non-adherence to a ‘first-best’ policy-package to lack of political will. Political determination is clearly an essential ingredient of policy formulation and implementation, but far from sufficient in order to gain credibility and achieve success.

Janos Kornai pointedly remarked that ‘Those who attach intrinsic value to democratic institutions must consider in their proposals the existing power relations and the rules of parliamentary democracy. We are not going to achieve much if we rely on advice of this kind: it is our job to advise you about what is good for your country and your job to take advice. If you do not take it, that is your problem. We cannot help it if your politicians are stupid or malicious’ (p. 5). This is a strong prodding to consider the political economy of reform in the post-communist countries.

Relatedly, one has to ask whether the advocated ‘first-best’ policies are actually realistic, irrespective of circumstances. For example, can one really believe that not paying wages and salaries to many people, who are still employed, is a sustainable policy which can durably defeat high inflation? Alternatively, what is the meaning of a small-consolidated budget deficit if arrears as well as the quasi-fiscal deficit are growing? In addition, is the non-inflationary financing of the budget deficit sustainable when its service is skyrocketing because of very high positive real interest rates? It appears that, sometimes, some pundits disconnect what is desirable – from a results oriented perspective – from what is achievable, in terms of policy, under the circumstances.

## **2.2 Two major underplayed issues**

Two issues, in my view, have been constantly underestimated. One issue regards the burden of the past (backwardness) of the former command systems; the other issue refers to the magnitude of required resource reallocation in relation to the new relative prices dictated by liberalisation and to the opening of the economy.

### *The burden of the past*

The post-communist societies of Europe are societal entities that show common (structural) traits, but also major discrepancies; the latter can be linked with the different pre-communist legacies (the former Czechoslovakia, as a leading industrial country during the inter-war period, is the most conspicuous example) and the different brands of national central planning, in terms of relaxation of direct controls and economic policy choices.

The different histories explain widely different incomes per capita (tabel.1 and 2), why market institutions vary qualitatively among the national environments and why macro and micro-disequilibria differed among them on the eve of 1989. Undoubtedly, Hungary, the former Czechoslovakia and Poland had a substantial competitive edge in starting the process of managing transition. Unsurprisingly, all these countries have fared better than the rest in their stabilisation programmes, although their recipes were not similar, as some would argue.

Backwardness bears considerably on the potential for overcoming the performance deficit; it points, on one hand, at the lack of specific knowledge of individuals and of society as a whole and at the constraints for genuine institutional change and, on the other hand, it suggests that there is much scope for a system to get outside what can be conceived as an ideal tunnel of evolution. The stress put on the burden of the past is meant to warn against its dragging effects and an unfavourable *path dependency*, from which it may not be easy to break away.

Backwardness makes it harder to overcome the fragility of the emerging market institutions and enhances the potential for the dynamics of change to get out of control; it does enhance institutional fragility, which was underestimated by policymakers and their advisers. As Peter Rutland rightly points out 'in a travesty of Hayekian logic, it was assumed that market institutions would be self-generating' (1994/95, p.11).

The sintagma *institutional fragility* has been mentioned. Apart from the insufficient analytical attention paid to the institutional build-up in the transforming societies in Europe, one has to consider the seeds of instability produced by this fragility. The poor capacity of immature institutions to perform needs to be mentioned in this context. For example, the debate on universal vs. narrow banks (on whether and how banks should be involved in resource allocation) is quite relevant for the concern immature market institutions create in terms of enhancing instability and uncertainty in the system. Institutions explain also the size and the collectability of budget revenues (tabel.3).

From a broader perspective one can pose the issue of the *governance capabilities* of the political and economic elites of these countries – to what extent these elites are capable to induce and manage change (transformation) when so much fuzziness, volatility and uncertainty is prevailing. One can also assume that institutional fragility will bear significantly on the nature of capitalism in the region.

### *The magnitude of resource reallocation: the emergence of strain*

In Eastern Europe, the structure of the economy and the legacy of resource misallocation, have put the system under exceptional *strain* once the combination of the internal shocks (engineered by reforms, or, simply, triggered by the uncontrolled processes of system dissolution) and external shocks occurred. (D.Daianu, 1994, 1997).

What are the major implications of this *strain*? One is that these economies can easily become exceedingly unstable and that their capacity to absorb shocks is quite low; these economies have a high degree of vulnerability! Another implication is that policymakers face extremely painful trade-offs and that, in most cases, unless policy is clever and sufficient external support is

available, the room for manoeuvre is in practice, quite limited. Finally, macroeconomic stabilisation in certain countries hides deeply seated tensions which, sooner or later, come into the open unless deep restructuring takes place (Russia is the most glaring example).

### 2.3. Sources of *policy succes*

Aside vision and the very quality of policy itself, I would highlight:

- the initial conditions (including the legacy of resource misallocation)
- the history of partial reforms (which made certain environments more ‘market-friendly’), with Hungary, Poland, and Slovenia being in the forefront.
- the regime change, which led to periods of institutional interregnum. Again, the countries which benefitted on previous reforms and some collective memory achieved better results (Blanchard, 1997);
- the role of foreign capital in triggering a virtuous circle. Particularly the last factor seems to have played a very significant role in the front-runner economies; this role is better understood bearing in mind the extreme complexity and complicated nature (the very high cost) of deep restructuring of economy. One can argue that some of the fast growing economies of Asia relied less on foreign capital and that, in their case, the essential factor was the very high savings ratios (35-40%). Undoubtedly, such ratios are good for economic growth and economic policy should strive to stimulate them. Nonetheless, I dare to say that geographic and historical circumstances make foreign capital play a special role in the post-communist countries.
- geography, well illustrated by the performance of the cluster of countries bordering the EU.

Policy credibility, itself, depends on how much structural adjustment the system can undergo in a period covered by the respective policy; and the capacity to adjust depends, basically, on *structure*, on the dimension of required resource reallocation, and on the quality of institutions as premises for policymaking. A ‘credibility paradox’ seems to be at play here: those who need to be more credible are not (cannot be) because of the magnitude of required resource reallocation and of overall institutional change, and their related costs – what I called *strain* in the system; whereas those who can afford not to undertake similarly painful changes (e.g. Hungary) enjoy more credibility due to the, relatively, smaller scale of needed structural adjustment. Obviously, a political element has to be factored in as well, which includes the *reputation* of policymakers. It is like in a “winners’ take all” situation, which was well illustrated by the way market sentiment turned against most of the countries in transition in the wake of the Russian financial meltdown.

Credibility and the boldness of policy can be much enhanced by political climate and various sui generis anchors, such as the prospects for joining the EU and NATO. This also explains why, where there has been a political backlash at the polls no major policy reversals occurred in most of the reforming countries. Nonetheless the question which automatically comes to one’s mind is what would happen if policy and social fatigue combine with receding prospects (for some, or most of the countries) to join the two institutions in the near future.

### 2.4 Reading the map of transformation: links to the future

2.4.1 Macroeconomic stabilization is necessary, but far from providing the benchmark between

success and failure.

2.4.2 Structural reforms are key to achieving macroeconomic stability, stability in general; whereas the marginal costs of delayed reforms increase over time there seems to be limits to how much one can speed up reforms.

2.4.3. Institutional build-up takes time; the lack of proper institutions, of social and organizational capital (trust) is inimical to the functioning of society –“Waiting for the Postman”!!!

2.4.4 Because of their major structural distortions (including resource misallocation) and the fragility of their institutions, the transforming economies have an almost in-built mechanism for subjecting themselves to intense *strain*. Very few countries have made big strides as far as deep restructuring is concerned and much of the potential *strain* has been mitigated by the effects of heavy capital inflows. It can be submitted that feeble deep restructuring maintains a high degree of actual and potential *strain* in the system. This issue needs to be emphasised since the resumption of growth on a large area may have caused more optimism than is actually warranted. One should not overlook that what is happening now is more economic recovery from an extremely depressed level of production – even if correction is made for formerly useless production – and that this was helped by relatively easily obtained efficiency gains; that, over time, unless investment ratios are high, unless there is constant upgrading of the quality of output (tradeables), and there is a good functioning of institutions, growth will stall.

2.4.5 The implosion of the Mexican economy at the end of 1994 and the financial crisis in East Asia, in an indirect way, the chaos in Albania in 1996 and the financial meltdown in Russia in 1998, in a direct way, suggest how fragile and vulnerable post-communist economies are; these events also show how deceptive macroeconomic figures can be when they are not supported by the strength of real economy and solid institutions. One should not forget that Mexico was hailed in the early 90s as a role-model all over the world; and, in the mid-90s, Albania, and Russia, a few years ago, were considered success stories for their macroeconomic stabilisation and other reforms.

The *fragility* and *vulnerability* of the transforming economies should be judged against the background of globalising financial markets. The East Asian crisis, the Mexican crisis, and also the hard times the Argentinean policymakers had in managing the ‘tequila effect’ (the currency board did not make the economy soundproof and IFOs money had to be asked for!) come to one’s mind. There are several aspects to think about here. One regards the link between the development of financial markets and the progress made in the real economy. It can be submitted that the degree of volatility of domestic financial markets would be exceedingly high unless there is sufficient restructuring of the economy. Conversely, it can be argued that capital markets do enhance restructuring which may suggest that one faces a chicken and egg problem in this respect.

There is here a policy conundrum, which outlines a multi-question one needs to answer: how would financial markets better serve the transforming economies and, implicitly, how should be they developed? Do financial markets influence the nature of capital inflows (when real interest rates are high and induce speculative inflows) and if that is the case what are policy implications? Is there a need for capital controls? I would argue yes: there should be controls on short-term capital flows and financial market liberalization should proceed carefully<sup>4</sup>. Another aspect is linked with the acute need for much prudence and wisdom in macroeconomic policy.

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<sup>4</sup> As Frederic Mishkin says, “although financial liberalization is a worthy policy goal, it does not have to be pursued with the neglect of the need to build proper institutional structures of supervision and regulation, in order to avoid financial disasters; this would imply a controlled pace of financial liberalization”(1996,p.41)



Another aspect to highlight is the urgent need to strengthen the supervision of the banking industry; since many banks are congenitally fragile, quite prone to poor lending, and heavily fraught by conflicts of interest; it goes without saying that better supervision should be exerted on financial institutions as well.

2.4.6 Persistent and high structural unemployment could become very burdensome for reform policies – a *hysteresis* phenomenon may develop quite disturbingly unless proper labour markets policies are developed. Current unemployment rates in the transforming economies are not exceedingly high in comparison with the European levels of the mid-nineties and this could assuage the perception of *strain*. However, several factors provide cause for concern. One is that the yardstick used is itself questionable taking into account the unemployment problem in Western Europe. A second factor is the weakness of safety nets; this problem acquires particular significance in the poorer post-communist countries, where the consequences of a ‘new type’ of poverty could be extremely serious (think that the Gini coefficient in Russia exceeded 60%, being close to the level in Brazil!).<sup>5</sup> And another factor is the fact that restructuring of large companies – which mostly need to shed labour in order to become profitable – is very slow, or, in practice, not taking place; this means that potential unemployment increases are still very significant.

2.4.7 The experience of Latin America and East Asia shows that widely diverging wealth discrepancies are not conducive to social stability and long-term growth.<sup>6</sup> The implied policy requirement is more than challenging since it needs to fit into the general pattern of market-based reforms which involve income differentiation; it also needs to help the transforming economies become more flexible (adaptable) instead of being mired into social rigidities – which would be fatal in a world increasingly subjected to the pressures of globalisation. In any case this is a domain which may critically test the governance capabilities of the elites in the transforming economies in the years to come; these elites would have to solve what Arthur Okun coined as the ‘Big Trade-off’ more than two decades ago.

One should also mention an increasingly intense *distribution struggle*, and an erosion of the consensus for societal change when many individuals appear as losers – once market forces start to reward people in accordance with merit, effort, good ideas, and inspiration, but also as a result of some workers’ misfortune to have jobs in bad (unprofitable) enterprises.

2.4.8 As to privatisation, what took many hundreds of years in the advanced capitalist countries is supposed to occur, through various procedures (more or less legal), in the post-communist countries, in a snapshot on the scale of history. It is not, therefore, surprising that everything surrounding this process is so highly charged emotionally – why so many hopes, dreams, reckless and ruthless actions, misbehaviour, and delusions are linked to it. All individuals want to be on the winning side, but markets cannot make them all happy. The nature of capitalism in the post-communist countries will be decisively influenced by the actual results of privatisation as a process. If privatisation results in the development of a strong middle class as the social backbone of the new economic system, stability and vigour will be secured, and democratic institutions will develop. Otherwise, the new system in the making will be inherently unstable – like the bad Latin American model – with politics quite likely to take an authoritarian route.

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<sup>5</sup> Including the potential for the appearance of aggressive extreme-left groups, liable to engage in domestic and international terrorism. The existence of extreme-right (fascist) groups would compound the danger.

<sup>6</sup> See also the late M. Bruno quoted by William Pfaff (1996). He was, at that time, Chief Economist of the World Bank.

2.4.9 Communism – as an economic system – functioned as a kind of poor and steadily declining (suffering from *economic euthanasia*) but, nonetheless, ‘welfare state’—what Kornai called a ‘premature welfare system’ (1994,p.16). The post-communist countries maintain among the most generous social welfare budgets in the world when calculated as a share of GDP; social spending budgets are between 15-30% of GDP as compared to 5-10% in the case of East Asian countries at similar income levels, for similar social programmes.<sup>7</sup> As in Western countries, where there exist powerful vested interests which oppose economic adjustment, in post-communist countries those who cannot compete on the markets have turned into a strong coalition of interests which can slow down, or even arrest reforms. This mass of individuals is most likely to fall prey to populist slogans and is obviously inclined to support left-oriented parties. Robert Gilpin’s observation, that adjustment is very difficult in welfare states, applies *mutatis mutandis* in the case of post-communist countries. It is striking how the need for western countries to reform their welfare systems compares with the post-communist countries’ need to restructure their public budgets.

2.5 A phenomenon, which reflects with much intensity the institutional fragility and the complicated nature and complexity of transformation, is the ubiquity of lawlessness – the ‘blossoming’ of organised crime and corruption. There is no doubt that much of it is just an outcome of activities becoming less hidden. It is also true that some of what appears as illegal activity is due to the still very fuzziness of the legal environment, and to the emerged need to privatise contract enforcement when official law enforcement capability is almost non-existent. However, there is also an element of novelty in this field, which, in certain cases, can take frightening forms and proportions. Where bankers, businessmen and journalists are murdered, this has an impact on the social psyche that is not favourable to market and democracy nurturing reforms.

A very detrimental vicious circle can be at play here. Thus, because of institutional fragility (actually, owing to the lack of socially accepted norms and of authorities capable to enforce, and protect them should the need arise) organised crime and lawlessness, in general, do proliferate. Simultaneously, their proliferation undermines the very effectiveness of the budding democratic institutions. Consequently, the so-called ‘proto-democratic institutions’ are likely to remain in a limbo state for a long period.

One can, normally, pose the following question: what kind of capitalism is being built in the transforming economies? An optimistic answer would be twofold. Firstly, the picture is too multicoloured for justifying an all encompassing answer – the intensity of the phenomenon is different in the various national environments (the Czech Republic is different from, let’s say, Ukraine) and, therefore, its consequences and prospects are dissimilar. In fact, different kinds of capitalism are emerging in the post-communist countries. Secondly, the presumption should be accepted that this phenomenon would recede over time in keeping with the unfolding of transformation. A pessimistic answer would highlight the vicious circle mentioned above – as a conspicuous instance of ‘path dependency’ – and the enhancing factor represented by rising unemployment and poverty among large segments of society, as well as the increasing mistrust of the citizenry as to an apparently impotent and corrupted government bureaucracy.. A pessimistic answer would also point out the danger that the tentacles of organised crime would increasingly influence the functioning of institutions, and encroach on the political process, ultimately, in a resilient fashion; something resembling organised crime as a phenomenon in Italy, or in Mexico and Columbia, would come into being, but it would very likely have its

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<sup>7</sup> Jeffrey Sachs, 1995b, p.2. Although I agree with the main point he makes, I think Sachs underestimates the importance of distributional effects entailed by reforms; a lot depends on the balance between winners and losers.

peculiarities.

Both Eastern and Western governments should not be complacent about this phenomenon, in the hope that it may prove 'benign' and useful for building up market-based economic systems in the long run. The creation of SECI (South East Europe Cooperation Initiative) reflects this concern.

### **3. What shapes policy?**

The emergence of the private economy (including the second economy) at the grass root level, and the creation of sui generis forms of financial intermediaries, occurred spontaneously in all the post-communist countries. However, there is another side of the process, which refers to institutional change by design; the latter can have a heavy dosage of imitation, or can present novel features.

It can be said, therefore, that institutional change is the result of the interaction between spontaneous change and large scale reengineering. This interaction will shape policy in the future as well.

#### ***Institutional change by design: are there any guiding principles?***

Firstly, the interaction between the realm of ideas and policy is to be mentioned. The neo-classical paradigm considers quick reallocation of resources and the maximisation procedures of agents. Simultaneously, a frictionless environment is taken as the standard and adjustment processes are viewed as being quickly triggered by price liberalisation. Rigidities are largely discounted which, further, would suggest that public intervention in managing adjustment is thought unnecessary. The neo-classical approach also underestimates the time-consuming nature of building up institutions and their impact on economic performance. The Washington Consensus illustrates this paradigm for transformation<sup>8</sup>.

Two other competing paradigms exist which provide a rationale for public intervention in the economy. One is the Neo-keynesian approach which takes for granted the imperfection of markets; information and transaction costs, rigidities all compound in portraying an economy in which adjustments cannot be frictionless and in which there can appear large externalities (positive and negative). Whereas some Neo-keynesians are quite ambivalent whether public intervention can be effective (Gregory Mankiw), others – like Joseph Stiglitz – are in favour of selective intervention. Stiglitz's work provided ammunition to the so-called post-Washington Consensus<sup>9</sup>. There are, also, economists (Alice Amsden etc.) who point the finger at the East Asian experience and emphasise that – in that case – public intervention went farther and constructed comparative advantages against the background of the operation of market forces.

Obviously, the paradigm embraced by policymakers cannot leave policy unaffected, be it stabilisation, trade, or industrial policy. Applying one or another of the other paradigms highlighted above demands understanding the reality of post-communism; huge resource misallocation, the precariousness of institutions, and the collapse of Eastern markets indicate the existence of much friction in the system and explain why production imploded.

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<sup>8</sup> "The 10 commandments" are described in John Williamson (1994)

<sup>9</sup> He says: "...failures of reforms in Russia and most of the former Soviet Union are not just due to sound policies being poorly implemented. I argue that the failures go deeper, to a misunderstanding of the foundations of a market economy as well as a misunderstanding of the basics of an institutional reform process...reform models based on conventional neoclassical economics are likely to under-estimate the importance of informational problems, including those arising from the problems of corporate governance; of social and organizational capital; and of the institutional and legal infrastructure required to make an effective market economy. They are also likely to underestimate the importance of the creation of new enterprises..."(1999, p.1)

When viewed in relationship with institutional change and structural rigidities the dispute shock therapy vs. gradualism loses much of its relevance for change cannot take place via a ‘big bang’. At the same time, gradualism is out of touch with reality when it ignores the institutional dissolution of the former command system, the collapse of external markets, and, consequently, the inability to control change from above (as in China, for example).

Policy-making is also influenced by the competition between different models: the Continental vs. the Anglo-Saxon. It is true that globalisation brings models nearer and this is pertinently exemplified by the debate on corporate governance and labour markets. However, differences among variants are still substantial and rooted in institutional specificity, which predetermines economic and social performance. This competition affects policy-formulation in the transforming economies in domains like the role of capital markets (vs. banks) in allocating resources, the size of the public sector, the role and the nature of state intervention in the economy, the content of the welfare state, etc. Clearly, the countries which want to join the EU have to shape their institutional frameworks accordingly.

A clever policy needs to incorporate the effects of technological progress and of globalisation; namely, the need for flexible markets, for higher adaptability, has to be reconciled with the demands of building up human capital and of creating public goods as positive externalities. This is why the debate on the capitalism in the making in post-communist countries is justified and highly relevant for policymaking.

### ***The pursuit of public purpose: the need for public policies***

The magic words of transformation are liberalisation, privatisation, stabilisation, and opening. Nonetheless, it would be hard for someone to dispute on solid grounds the need for public policy in the transforming economies. I quoted Larry Summers on the pursuit of public purpose, at the start of my article. Likewise, J. Stiglitz and Nicholas Stern, the chief economists of the World Bank and the EBRD, respectively, stressed ‘A well functioning economy requires a mix of government and markets. The balance, structure and functioning of that mix is at the heart of a development strategy’ (1997, p.1). The real issue at stake is, therefore, the nature and the scope of public policy. For instance, after the events of recent years, in most of the transforming economies, can one deny the need of proper regulations regarding banking industry and capital markets?

Some – such as Kenichi Ohmae – would argue that economic globalisation destroys the effectiveness of national economic policy, implicitly, of public intervention; moreover, the relevance of the nation-state, as a relevant economic entity, is strongly questioned. However, what economists call the ‘one price law’ does function as a tendency and imperfectly; and the claimed mobility of factors of production is much too incomplete and asymmetric in the contemporary world. Let us think only of the ‘mobility’ of labour and of technological progress – the latter seen as an outcome of ‘clusters’ of technologies (Michael Porter).

In the world, there are powerful factors at work, which push globalisation. Moreover, values and norms specific to industrial civilisation are to be highlighted, aside from the integration of financial markets. Such factors have a strong impact on the formulation and the effectiveness of national policies. Nonetheless, globalisation should not be equated with uniformisation and, particularly, equalisation of conditions; globalisation can coexist with and even deepen, economic gaps.<sup>10</sup> Additionally, if attention is directed to the soft portion of a societal aggregate

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<sup>10</sup> See William Greider (1997) and recent UNDP data

– that which ensures social cohesion, and which makes individuals become members of a community (*Gemeinschaft*) – things get more complicated for analysis. Related to the ideas mentioned above it is worthwhile recalling Ernest Gellner's thesis that nation states can be a driving force behind modernisation (catching-up).

The fact is that the world is made up of national aggregates which reveal different economic dynamics. If the world were atomised, and borders (not only geographic) were irrelevant, no major economic discrepancies would be detectable among areas. This is why it makes sense to think in terms of the quality of national institutional settings and of national economic policies. If this line of reasoning is accepted, public policy gains its rationale as macroeconomic policy, economic policy in a broad sense – including foreign investment, education and development of infrastructure – trade policy, social policy, and last but not least, the working out (or the preservation) of a societal model hypostasised by values, principles and a 'social glue'. An explicit or an implicit 'social contract' between the citizenry and government is also to be included.

Public policy refers to *norms* and *procedures* as well; without them policy could easily degenerate into malignant authoritarianism.

The developing world is multicoloured with respect to the quality of public policies. Thus, past decades in Latin America show how not to practise public intervention. Exacerbated populism in economic policy, large budget deficits (which were financed inflationarily), overbloated public sectors, extreme import substitution and heavy subsidisation of unperforming industries, social and political clienteles, huge income inequalities, etc, are features of the ill famed Latin American model. A glaring example of what bad public policies do is Argentina of thirty years ago, which changed from a prosperous country before the Second World War into an economic mess during the years of Peronist policies. Likewise, Venezuela, in spite of its enormous riches showed very poor public management in recent decades. In addition, there are examples in Southeast Asia where public policy proved successful. The results of the Asian Tigers in the seventies and the eighties were due, essentially, to sound macroeconomic fundamentals, high savings ratios, and clever public intervention in the economy. Their experience teaches the importance of export orientation, of educational build-up, and of infrastructure development. At the same time, the recent very severe and prolonged financial crisis in East Asia highlights the economic merits of transparency, self-restraint, and strong institutions including healthy financial entities.

In history one hardly finds examples of successful economic catching-up which did not involve exceptional vision and effective public policy. Therefore, the question is not whether public authorities should intervene in the economy; it is how and how much they should. I even dare to say that the abysmal record of economic transformation in most of the post-communist countries may lead to a resurrection of development economics. In this context I value the World Bank's Comprehensive Development Framework(CDF)

A conclusion is easy to infer: although there is a demand for it, the construction of a wise and effective public policy is a hard task for policymakers bearing in mind the risk of committing major errors. Moreover, it can be argued that, in the case of post-communist countries one is faced with an almost innate lack of capacity (including the mindset) to formulate and implement public policies – which is due to the legacy of communism. But this state of affairs cannot

obliterate the need for public policy, for rallying efforts for the sake of modernization.<sup>11</sup> The big question is therefore: how to work out and implement clever public policies, which, on the one hand, should unleash the forces of creativity and the energy of individuals, and on the other hand, should solve problems which require state intervention – without bringing the demons of totalitarian thinking and practice back to life.

### 3.1 Three major policy challenges

I would submit that post-communist countries face three historical challenges:

- a) institutional construction (transformation);
- b) economic catching-up;
- c) ensuring social stability.

In what follows, several initial remarks are made on these challenges. Firstly, the special historical and political context has to be underlined, namely, the transformation of the former command systems into market based democratic polities. The *political dimension* of the ‘Great Transformation’ started in 1989, implies the conquest – by citizens – of political freedoms and the build-up of political democracy. Therefore, the thesis can be advanced that, in Central and Eastern Europe, authoritarian<sup>12</sup> forms of government, of managing transformation, would be rejected by citizens and would cause themselves instability (I do not include here the CIS and most of the Balkans). I should admit that another logic could be applied as well: reforms can bring about a certain instability and the inability of authorities to administer them would favour the accession to power of authoritarian governments. Russia and other former Soviet republics – but not only them – can easily fall into this pattern. For this reason, analysis needs to be differentiated and consider various circumstances, changes, which can consolidate, or not, democratic processes.

This thesis should be judged from the perspective of other modernisation efforts – like in Asia where authoritarianism has been conspicuous for decades now.

Secondly, a distinction should be made between modernisation and economic growth, though, in a broad sense, the first notion comprehends the latter as an expression of the dynamic performance of institutions. Simultaneously, dealing with structural *strain* and macroeconomic stabilisation are put under the umbrella of sustainable fast growth since they condition the latter.

Finally, the conventional analytical matrix represented by notions such as price liberalisation, stabilisation, and privatisation cannot capture each of the three major challenges.

Institutional change has not been neglected in debates but the burden of the past and the ‘path-dependency’ issue need to be given more attention. In this respect, two important aspects deserve to be underlined. One refers to the impact of institutions on overall economic performance; poor institutions explain, inter alia, low yields in agriculture, the fragility of the banking sector, or the malfunctioning of democracy. Where there is institutional disarray, or chaos (like in Albania), one may have to wait a long time for ... “the postman”! Here the key issue is the strengthening of state institutions.<sup>13</sup> Institutions can also explain why the entrenched patterns of corporate governance make the use of resources inefficient. The second aspect

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<sup>11</sup> Apart from the situation when modernisation can be viewed as a “dissolution” in a modernising transnational space – such as the EU, in idealistic terms. But is such a vision realistic taking into account that accession implies having achieved already a certain level of development which conditions performance, and that even the EU is facing some deep structural economic difficulties.

<sup>12</sup> *Authoritarianism* should be equated with *paternalism*.

<sup>13</sup> I am referring to Kevin Costner’s movie where the Postman exemplifies the attempt by individuals to restore some order, a sense of belonging to a society.

regards the existence of two types of fragility: one linked with the infant nature of institutions; and another type related to the extraordinary magnitude of the changes under way (*structural strain*).

It can be inferred that both pre-communist and communist histories influence a post-communist country's transformation. Thereby, a modernisation strategy – where it does exist – needs to consider the difficulties of institutional build up and the available options; on one hand, 'natura non facit saltus', on the other hand, the 'making of history' (as against the mere presence in history) and the overcoming of structural traps asks for big 'historical jumps', which imply vision and wise choices in the realm of institutional construction and modernisation strategy.

Rapid economic growth is not easy to achieve for there are no easy blueprints. Although conventional theory suggests that any economy that possesses cheap labour has the potential for catching up, ultimately what matters is the quality of institutions and of human capital. Again one can see the importance of institutions which determine the way resources are combined and used, and the overall performance of society. It should also be mentioned that institutions explain the size of savings ratios (as a premise for fast economic growth) and the attractiveness of a national space for foreign capital.

Ensuring social stability is going to be a major challenge in the years ahead. The lessons of history teach that distribution tensions in production and consumption affects the homeostasis and performance of societies (economies). Globalisation of trade and financial markets puts societies under much *strain* and enhances social fragmentation. The latter can be detected all over the world, including the most economically advanced countries. Therefore, in the transforming societies, wherein market reforms (including possibly ill conceived privatisation schemes) are likely to lead to rapidly increasing economic status differentiation, and against the background of citizens' expectations (who all expected from revolutions to be better off soon), even fast economic growth can be accompanied by social tension if wealth discrepancies are perceived as too large. Social instability becomes an unavoidable phenomenon in an environment which produces marginalised people – or what the current French political terminology calls 'les exclus' – systematically and on a large scale.

From this perspective can be assessed the dire need in the post-communist countries to reform 'premature welfare states' since their total dismantlement hardly seems a realistic policy option (much like in Western Europe). In this context should be judged the importance of human capital build up, and of public education, as a means to ensure equal opportunities to all citizens.

The current debate, in the West, about the evolution of capitalism (*The Third Way*) has relevance for transformation as well.<sup>14</sup> Long-term, transformation needs to respond to two sets of pressures, domestic and external. This assertion is made for its implications in both conceptual and policy terms. For it is one thing to view transformation, in a post-communist country, as a simple automatic by-product of world evolution after 1989; and it is something else if transformation is viewed as a modernisation process that has a powerful domestic engine. Does it make sense to talk about a project of society for what we are building in post-communist countries? I think it does. Talking about markets and democracy in an oversimplified way is insufficient analytically and cannot help to identify solutions to the acute problems confronting economic policy in the short and the long run.

### **The role of institutional capital**

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<sup>14</sup> In this subject, see also Robert Barrio (1996), Zbigniew Brzezinsky, Daniel Cohen, Will Hutton, Anthony Giddens (1998) Paul Kennedy, Paul Krugman, Jeffrey Madrick, Geoff Mulgan, Lester Thurow, J.D. Davidson and W. Rees-Mogg (1997), etc.

High savings ratios and the formation of human capital are essential for promoting rapid and sustainable economic growth. This is what both conventional and more recent growth theory underline. However, the primary determinants of growth and modernisation are to be sought elsewhere, namely, in the realm of institutions; the latter determine the quality of policies and the overall performance of economy. This thesis is extremely important when applied to the case of transforming economies, which face extraordinary challenges, particularly in the field of institutional build-up.

An attempt to capture institutions conceptually would pin attention on four forms of institutional capital: *social capital*, *civic capital*, *leadership capital*, and *cohesion capital*. Among these forms of institutional capital, there are visible linkages; their analytical separation is, however, useful.

*Social capital* refers directly to the norms which govern interactions among individuals, groups, and organisations. Kenneth Arrow (1974), Robert Putnam (1993), and, lately, Francis Fukuyama (1996) stressed the importance of social norms – as a form of social capital – for economic development. The difficulty for economic analysis is linked not necessarily with the fuzzy nature of the concept, but with the way institutions develop – in an incremental way, but without a mechanical determination. The import or the imitation of institutions can be practised without, nonetheless, ensuring their required organic assimilation and social embeddedness.

*Civic capital* regards several elements. Among them an essential role is played by the system of institutionalised checks and balances, which is supposed to control power (those mandated to run public affairs). Another element is represented by civic organisations. Civic capital implies a generalised state of mind, of civic behaviour. As in the case of social capital, civic capital poses a critical question: are not these two forms of institutional capital – when seen as sources and resources of transformation (modernisation) –, themselves, a product of an advanced degree of societal development. Namely, do we not have here a vicious circle? This question indicates the tension between organicism and constructivism as approaches to transformation (modernisation). In the post-communist countries, during extraordinary times, decision-makers are almost condemned to be constructivists. Their actions need however to be wise and consistent in order to avoid major historical blunders.

*Leadership capital* becomes an issue whenever it is acutely needed. The real world of the life of organisations shows that leadership comes to the fore especially during hard times, when critical decisions are to be made. Wouldn't it be better that decisions, themselves, be subject to optimisations which should rid us of uncertainty, 'artistry', and arbitrariness? On the one hand, this is practically impossible; on the other hand, it may be quite undesirable since optimisation algorithms are likely to impede creativity and breakthroughs, which lead to competitive edges, to progress in general. Moreover, transformation as a led-process involves more than the impersonal forces (mechanisms) of markets at work. Leadership, which involves vision and determination, cannot and should not be downsized to mere co-ordination.

Do post-communist countries have a significant stock of leadership capital? A pessimist would answer that a country's economic and political elites are, themselves, an 'infant industry', and that spectacular results should not be expected. An optimist would stress the lack of homogeneity of humans, the existence, always, of exceptional individuals who can rise to the challenge of history, provide a sense of direction, and run organisations (social aggregates). In any case, since post-communist transformation is going to be a lasting process the performance of post-communist countries' political and economic elites must have a high common denominator along a longer period of time – even if some of these countries have the chance to use NATO, the EU, and other international structures as institutional and policy anchors.

*Cohesion capital* is a form of institutional capital, which may sound esoteric to some. I



thought it useful to introduce it within the quadrangle by taking into account the importance of social stability for the long-term evolution of society. Here, as well, one encounters the dilemma: is social stability a prerequisite or a product of the process? In the same equivocal way, the answer springs into the open: social cohesion helps development, or going through difficult times, but is, itself, influenced by the process. It should be mentioned relatedly that the stock and the flow of social cohesion depend on the functioning of institutions. Therefore, a lot depends on the choice of institutional constructs, which lend regularities to and give birth to norms in the overall functioning of society. From this perspective, it is fully justified to ask which kind of model is more likely to ensure a higher degree of social cohesion concurrently with sustainable economic growth. Clearly, this is a question, which has significant policy implications.

#### **4. Looking ahead**

One can use a matrix of circumstances and challenges in order to differentiate the various “slots” post-communist countries find themselves in.

Among circumstances I would range: the state of economies; the strength of institutions (including state institutions –which becomes a key variable); inter-ethnic relations; geopolitical location; commitments to join the EU and NATO, etc

Among short-term challenges I would include: sustain or resume growth; check (stop) inter-ethnic strife<sup>15</sup>; fend off attacks on state institutions (dealing with organized crime)

Among longer term challenges I would mention: strengthening institutions; achieving sustainable growth (catching up); social cohesion (fighting poverty); social capital (fighting corruption); empowering citizens (strengthening democracy).

It is not hard to show that the matrix suggested above permits a taxonomy which indicates different probable evolution paths for the transforming countries. These paths can be linked with how society evolves, with the links countries forge with the EU and NATO. The Visegrad Group, Slovenia, and the Baltics are expected to join the EU before the end of the decade. Bulgaria and Romania still need to belabor pretty complicated situations, which are influenced by geography as well. In the Balkans things are far away from having been solved; here there is need for managing short-term with long-term crises at a time when the political geography of the region is not yet clear<sup>16</sup>. In Russia and Ukraine economics are intricately intertwined with politics and both will be under the spell of fuzziness for years to come.

##### **4.1 Variety of capitalism?**

One can already try to identify different evolving models of capitalism among the post-communist countries, and seek also to speculate on the intensity of cultural and geopolitical (Western Europe’s vs. Russia’s) influence in each case. This variety of models has to be judged in a substantive and a formal sense. Formally, all these countries are implementing market reforms, and some of them signed Association Agreements with the European Union. It can be said, also, that these agreements, and the other links with the pan-Western European institutions, have created a sort of an evolution guiding ‘straitjacket’ – which can be seen as synonymous to the ‘anchor’. Nonetheless, post-communist countries differentiate among themselves in terms of: the quality of actual institutional development; the quality of macroeconomic fundamentals; and the resultant economic performances. These qualitative differences – many of which are of an intangible nature – are essential when screening the prospects for each individual country.

Countries like the Czech Republic, Hungary, Poland, Slovenia seem to go the Western way,

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<sup>15</sup> In the case of Russia this is more complicated when it involves separation attempts (recently, in Dagestan)

<sup>16</sup> There are basically four protectorates in the Balkans.

though one cannot – and should not – dismiss possible serious stumbling and setbacks on the road. The Baltic countries are moving along the same model, although at a slower pace.

More vacillating, though making strenuous efforts, are Bulgaria and Romania, which are burdened by the effects of delayed reform measures, including privatisation, and the relatively more complicated communist legacy.

For many post-communist countries (in the Balkans and the CIS) the danger is to fall into the institutional traps of a bad model – with kleptocracy, authoritarian politics, ubiquitous corruption, socially damaging growing income inequality and intense social strife. Such an evolution, should it be sealed through early accession of some countries into NATO and the EU, would accentuate the divide among the European post-communist countries. It may even cause intense disappointment among population at large, whose tolerance for the costs of reforms has been significantly sweetened (until now) by the promises of joining the two Western clubs. This would, clearly, have important consequences for ‘high politics’ on the European continent and would have implications on the shaping of spheres of influence; it would also fit the logic which says that accession is conditional on actual individual performances.

In a different vein, one could argue that such a policy-accentuated divide is shortsighted to the extent it neglects the different initial circumstances and other geopolitical considerations. For example, could one overlook the bilateral Romanian-Hungarian relationship in view of the precedent created by the ‘discipline’ imposed by NATO on Greece and Turkey. Additionally, one could argue that the best way to fight social and political anomie in various countries is via integration and the avoidance of discriminatory gestures.

It can be stated that the more laggard a transforming country is, and the closer it is to Russia geographically, the more critical for its future is the nature of capitalism in the latter country. Here I have in mind not only the “gravitational power” of Russia, but, in particular, the high uncertainty surrounding evolution in that country. Conversely, it can be submitted that the closer is a country geographically to the EU, the more likely it undergoes the influence of the EU ‘anchor’. A similar thesis can be submitted regarding the nature of domestic politics, with Russian developments providing a strong demonstration effect, if not direct influence.

What are then the prospects for Russian capitalism? “... the new economy is very much market-based, but it is also «anarchic», predatory, corrupt and oligarchic... unfortunately, the maldistribution of wealth and power is likely to give Russia a rentier economy that fails to provide the competitive dynamism the country desperately needs and its elite expects. It will also make democracy less workable, since it must pit a deprived and resentful majority against a wealthy minority”<sup>17</sup>. One danger is populism but the more likely outcome is repression’.<sup>18</sup>

The growing profile of those who advocate a more authoritarian rule in Russia, and the likelihood for it to come into being, can be judged also by the rising number of high-ranking military (members of the secret services) people in politics (government). The temptation of authoritarian rule can be discerned in other post-communist countries as well, which is explained by the mood of large segments of the population – who want some ‘order’ restored.

## 4.2 EU enlargement

The Euro was officially launched as the common currency of the EU on January 1st of 1999. This event is a milestone in the construction of the Monetary Union, in the deepening of the EU; it is also a specific response to the ongoing intense debate on the future shape and content of the

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<sup>17</sup> Christa Freeland, 1995

<sup>18</sup> ‘Today’s Russia makes excruciatingly plain that liberal values are threatened just as thoroughly by state incapacity as by despotic power’ (Stephen Holmes, 1997, p. 32).

Union, which goes beyond the foreseen and unforeseen implications of Germany's reunification and the collapse of communism in Europe. While *deepening* is a euphemism for the need to rethink (reengineer) the Union under the current historical circumstances, *enlargement* connotes the exigency of remaking the architecture of the Union by taking into account the changed geopolitical map of Europe. In this new context takes place the creation of the Monetary Union (MU) which, according to a strand of thought, is the means to further the integration of Europe by not slowing down the process to the lowest common denominator.

Different 'cultures of stability' (Stabilitätskulturen) and different approaches to political integration clash in the battle for deepening the EU. Related to the controversies surrounding the MU I would emphasise two issues. One regards the relationship between the MU and the economic challenges facing the member countries. As remarked by the President of the Bundesbank, Hans Tietmeyer, the monetary union is 'no panacea' for Europe's ills. Therefore, the MU should not be seen as a *deus ex machina* that can solve the structural problems of the member countries. The second issue regards consequences of the formation of the single-currency area for the Eastern enlargement of the Union. The formation of a 'hard-core' would have important implications for the future dynamics of the Union and would send several messages. These messages, *inter alia*, are: that a multi-speed Union is in the making; that 'delinkages' (fractures) are possible and quite likely, in spite of the avowed commitments to convergence of development levels; that the economically stronger post-communist countries could join a 'soft' area of the Union in a foreseeable future (most optimistically, around year 2004-2006); that new cleavages are likely to appear both inside the unified Europe (EU), and between the latter and other European countries, etc.

A major political question is what can be done so that seemingly unavoidable cleavages – in a multi-speed Europe – do not imperil stability and security on the Continent. In this respect, obviously, I have in mind the special case of Southeastern Europe, which is mired in political and economic difficulties, and interethnic conflicts.

Likewise, the state of economies in Central and Eastern Europe will help, or not, their intention to become members of the Union. If it is hard for some relatively advanced market economies (like Italy, Spain, and even the UK) to comply with the requirements of economic policy discipline within the EU, it is easy to imagine what could happen with countries that are much more likely to experience relatively high inflation rates, and which are prone to incur large budget deficits in the future owing to powerful social pressures. Is it realistic to assume that CEE countries would be able to submit themselves to the financial and monetary rigour of the Union? Or, maybe one has to think that the Union will develop a variable geometry and, consequently, the CEE countries will be able to join the 'soft' group at the beginning, or form an even 'softer' group on their own.

But even in such a case, only the best performing CEE countries would have a reasonable chance to cope with the competitive pressures implied by membership in the Union.

### ***The role of geography***

Geography is important in Europe and geopolitics plays an important role in understanding countries' specific goals and motives. Geography can also help explain the prospects for EU enlargement. For instance, in Germany's case, its Eastern neighbours present a strategic interest in severas respects and this is why Bonn supports their accession into the EU. As a well known German journalist remarked 'the stabilisation of Germany's immediate Central European hinterland is the more urgent task' (J.Joffe)

Even in pure economic terms, Germany's Eastern neighbours present attractiveness, which compares not unfavourably with the less developed (southern) members of the EU. An article in

the leading German journal of foreign affairs notes several assets which make Central and Eastern Europe and, especially, the Visegrad Group a preferred zone of economic interest.<sup>19</sup> These assets are defined as: a development potential which is considered to be 'much greater' than in the peripheral regions of Western Europe, the geographic proximity, the labour skills and the standards of research and training, a structure of production which is 'much more advanced than that of the southern members of the EU', and very low wage levels (see Table 4). The same German journalist considers that Central European countries, 'above all the Czech Republic and Slovakia, are Germany's Mexico': 'next door, and with workforces that offer high productivity rates at about one-tenth of German wage levels. Their markets are ideally suited for penetration'. Available figures support this outlook. Thus, according to data provided by Commerzbank, over a third of the merchandise trade carried on between Central and Eastern Europe and the OECD states is done with Germany.<sup>20</sup> The same source mentioned also that, in mid-nineties Germany's exports to the Visegrad Group countries were by 15% higher than its deliveries to East Asia. Concurrently, almost 10% of Germany's direct investments went to these four economies, up from only 0.5% in 1989. Germany is also the main trading partner of other post-communist countries. It is fair to assume that, over the long term, German investments in those countries would grow considerably as well.

One can easily imagine a scenario according to which Germany will expand and deepen economic links with its Eastern neighbours, much to the chagrin of other members of the EU. Should such a dynamic take place it would have many and significant implications for future developments in Europe, for the distribution of economic power and of political influence among groups of countries. Such a scenario would gain in likelihood should the process of European wide integration stumble, or slow down.

The Mediterranean members of the Union, which fear the competitive pressures of additional low-wage members, feel to be increasingly under the threat posed by a destabilising Balkans or the northern African fringe. Trade-offs and dilemmas can be easily detected here as well. It is clear that the different perceptions between France, Italy, and Spain on one hand, and Germany and the Nordic countries, on the other hand, regarding the security threats to Europe will be a major contending issue for years to come.

It can be submitted that how CEE countries' quest for accession is treated depends also on bargains and compromises reached within the EU, and among its most important members.

It can be expected with a high degree of certainty that Germany, in particular, because of its growing economic power, will get a higher profile in the way decisions are made within the EU. In addition, I would submit that this is going to happen irrespective of how the further construction of the EU takes place.

With respect to the EU, it remains to be seen whether the different political and economic weights of the current members will facilitate the making of fundamental decisions including the attitude vis-à-vis Central and Eastern Europe. Much depends on how prerogatives are split between Brussels and the national governments of the member countries and, also, on the mechanics of and the human touch behind the decision-making process.

One can pose a related question. Is the EU ready to undergo fundamental revisions, which should correspond to the new reality in Europe and to the need of integrating economically and politically the post-communist countries? Likewise, is the EU prepared to move forward viewing enlargement as a way of helping the process of systemic transformation in the post-communist countries by taking into account their current fragility? Is the EU ready to undertake programmes and projects, normally carried out in its poorer member states, which should precede and enhance enlargement? Again, one is forced to return to the conclusion that the big

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<sup>19</sup> J. Noetzold, 1995

<sup>20</sup> Idem

push now cannot take place without strong leadership and a vision, which should encompass the whole of Europe. Will Romano Prodi and Javier Solana change the vision? It remains to be seen.

### **The main economic issues**

There are several issues which make up the economics of the relationship between the EU and Central and Eastern Europe.

Regarding trade, the conventional wisdom is that the low wage countries of Central and Eastern Europe pose a big threat to several of the weaker sectors of the EU, which is a perception frequently met in the West. This policy rationale is publicised in the Western media and has become part of the public consciousness in Western Europe. The public debate surrounding this issue resembles much that which accompanied the formation of NAFTA, the North Atlantic Free Trade Area. Likewise, the menace to jobs was the stick wielded by politicians, some technocrats, and trade unionists.

What is very likely and much less known is that the European Union has been running trade surpluses. It is true that, in a bilateral relationship, the counterpart of sizeable capital inflows is a considerable trade deficit, and one may think that this is a proper pattern for structuring East-West European economic relations for years to come – as a reflection of a presumed joint effort to build up the economies in transition. However, things need to be seen in a proper light. Thus, although the CEE countries trade more than 60% with the EU, their trade is not exclusively bilateral; this means that they could get capital inflows from other sources as well, which may allow them to run smaller trade deficits with the EU. Additionally and what is more important, the trade deficit in itself does not say much about the potential of CEE countries to sell on Western markets. A country can incur the same trade deficit at widely different volumes of its exports and imports. This fact may not be so important for the West, where the economies are operating close to their capacity levels, but it is of vital importance for the East where the level of economic activity is still much depressed; for Central and Eastern Europe an export drive would be tantamount to the revival of their economies through what economists call an export multiplier effect.

While Central and Eastern European countries are very open to trade than their Western partners, they are a long way from being as sophisticated as the latter in terms of the utilisation of non-tariff barriers. In addition, it is well known that these barriers are frequently a much more serious impediment to trade than tariffs.

A natural consequence of the protectionistic stance of the EU is that CEE countries may have to reconsider the benefits of almost total 'unilateral free trade' and try to protect themselves.

The discussion about foreign investment concentrates on its impact on domestic jobs in the West. There are some who emphasise that, instead of investing at home, Western companies are running away with jobs towards the low wage countries of Central and Eastern Europe. There are several counterarguments which need to be made in this respect. One counterargument is that foreign investment can stimulate trade significantly, and the figures indicate clearly that Western Europe has benefited from the functional economic opening between the two parts of Europe. Therefore, one could surmise that, on balance, net job creation was positive in Western Europe. Secondly, the capital flows into Central and Eastern Europe have been much under what was expected immediately after 1989. It is no surprise, in this context, that Hungary has been taking almost half of all the external inflows to the region. In her case, one can see the fruits of market reforms which were undertaken well before the demise of the communist regime. Together, Hungary, the Czech Republic, and Poland got almost 3/4 of the total FDI inflows into Central and Eastern Europe, in the period 1990-1997<sup>21</sup>. And a final counterargument: it is not higher

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<sup>21</sup> Transition Report, 1998, p.81

investment that could provide the main instrument for dealing with high unemployment in Western Europe. The functioning of labour markets, the remaking of the institutional set-up, the redesign of the welfare system, and better education would have to do the primary job to this end.

Labour mobility is a much debated issue since it could turn into highly perturbing immigration for the West and could exacerbate domestic tensions. Laszlo Valki and Laszlo Csaba made, nevertheless, a valid point in this respect by referring to the experience of the United States, where an income difference of 1:3 was the threshold which induced substantial movement of people; above that, each percentage of income differential caused 0.026% migration. Their view is that this fact does not support the visions of Central and Eastern Europeans' pouring into the other half of Europe, 'since the differences in standards of living, measured realistically, through purchasing power parity, do not show a larger difference than 1:2.5 or 1:3' – see also Table 1.

I would make several additional comments on their worthy observation. First, it does apply particularly to the more developed post-communist countries. Secondly, for the latter there is already a safety valve created by the more favourable treatment of their citizens by the Western neighbouring countries. Thirdly, one should think also of the distributional effects of reforms on migration; these effects could be quite significant in the less developed countries of Central and Eastern Europe. And finally, I would consider also the potential pressure exerted on labour markets in Eastern Europe by a possible increasing inflow of people from Third World countries; some of the CEE countries have turned into immigration countries. This pressure may stimulate Central and Eastern Europeans to search for work outside their countries. This inflow may increase considerably in the years to come, and Central and Eastern European governments may not be able to stem it. Besides, it appears that organised crime, in its efforts to diversify its activities, has realised the potential and possible gains in this field. In the longer run, the threat would fade away since Western Europe needs substantial new entry into its workforce owing to its ageing population. There is a need to manage the problem in the short and medium-term.

Aid does raise the eyebrows of many Western officials for a couple of reasons. One is linked with the general development level of CEE countries, which would imply a heavy burden for the West in terms of development aid – assuming that enlargement were to occur in a few years. On the other hand, one could argue that the budget level in itself does not provide a good yardstick. Laszlo Csaba argues in this vein when he remarks that 'on the basis of the EU's present budgetary spending, only about 0.25% of EU gross domestic product is likely to be channelled in annual transfers to new members from the Visegrad Group. In Germany, by contrast, 5% of annual GDP is being transferred to the Eastern Länder'.

Another reason is that development aid to CEE countries would severely clash with the current competing claims on the EU budget – with the farmers' lobbies and the big recipients of development aid (Spain, Ireland, Portugal, and Greece).

A big dilemma for Central and Eastern European governments could be formulated in this way: let us assume that the EU decides to let them in, the near future, and also, that their institutional and legal build-up, as well as the functioning of their democratic institutions, match the provisions of the *l'acquis communautaire*. Does it mean that they will be able to cope with the competitive pressures of the EU environment after the removal of the temporary adjustment facilities, which cover a period of some years only? Can the CEE countries benefit – like the member countries of the EU do – on powerful enough safeguards in case something goes terribly wrong? Partially, the same question can be posed for the other side as far as the so called 'sensitive' sectors are concerned; but it is clear that CEE countries – particularly the less developed ones – could face infinitely bigger problems should not their low wages and learning potential compensate the considerably inferior overall productivity.

Certainly, one can add the possibility of using the exchange rate as a protective weapon in case they stay outside the ‘hard-core’ and, therefore, are not subject to the harsh discipline of the monetary union. This would be possible in the framework of an extended application of the concept of multi-speed Europe. Nonetheless, the Eastern European countries would still have to apply strict monetary and fiscal policies in order to avoid being led too much astray in terms of macroeconomic performances; and they would also have to view quite reservedly devaluation, since the latter could fuel inflation in an environment which is already prone to relatively strong inflationary pressures.

In any case, should the EU policymakers internalise broadly defined economic and security interests, a solid package of pre-enlargement supporting measures is required in order to ease the actual process of enlargement and reduce the psychological costs of waiting.

### 4.3 South-east Europe

Individual and collective tragedies marked the life of most people in South East Europe, particularly in the space of the former Yugoslavia, during this decade. Demons of the past reemerged. Civil wars and among newly appeared states, ethnic and religious conflicts, ethnic cleansing, long fights for redefining the political map of the region, make up the context of unimaginable sufferings of millions of people.

The termination of the current military conflict did not rid, however, South East Europe (the Balkans) of its deep-seated, latent animosities and other sources of conflict –of future conflicts. It seems to me that *crisis-management* in this region is of a different sort, in the sense of having to be projected long-term; it has to be an exercise linked with the nature of conflicts among the local players. It may take years and years, if not decades for injuries to heal. It may require the presence of “outsiders” for a long period of time. However, analogies with the end of the second World War should not be over-stretched.

The conflicts of the last ten years have outlined South East Europe as the very sick region of the Continent, with increasingly remote prospects for most of the countries, therein, of belonging to the select *Clubs* (NATO and the EU). For the purpose of analysis Greece and Slovenia are excluded from this injunction.

Whereas some of the new entities of the former Yugoslavia are still in the search of state stability and, economically, in a state of distress, Romania and Bulgaria have extremely difficult economic situations. Albania is the most glaring example of the pains the transition economies have in building up solid institutions. The region is the least developed of the Continent. It is fair to say that it is this region which causes most of the headaches for European policymakers and legitimates powerfully the talk about rising new divides on the Continent. It is true that a similar logic (language) can be applied on an East-West axis, when one refers to Ukraine and Russia as well. However, I would say that the sense of urgency is and should be much higher for the Balkans. What happened in the last ten years in this region, in terms of losses of human life, substantiates this assertion.

Tackling South East Europe, in my view, needs to be judged from two inter-related perspectives. One is the long-term exercise in crisis-management mentioned above, which aims at arresting (reversing) bad path-dependencies. The second perspective concerns reconstruction, which would have to be a two-pronged strategic endeavor: physical reconstruction (after the years of military ravages); and development (modernization), that includes the political process as well.

Thinking about the two perspectives hinges on several working assumptions:

- trying to redraw the borders in the region is a very dangerous game;
- unless the region gains a certain amount of stability and mutual tolerance among the local players, it would be hard to embark on region-wide reconstruction; mutual tolerance would involve changes in collective psychology;
- crisis-management does not exclude starting economic reconstruction; the sooner Serbia is involved in this process the better.
- crisis-management and resolution involves a tremendous effort for confidence-building (injury-healing), which would be well addressed by restoring economic ties among the local players; this means developing economic cooperation in the region, among the former components of the old Yugoslavia as well;
- crisis-management has to consider the extreme institutional frailty of the countries in the region and their heightened vulnerability to both domestic and external shocks;
- crisis-management needs to be more prevention- than reactive-oriented; to this end there is need for a better understanding of the roots of collective psychology in the region;
- clear prospects of economic reconstruction would give the people in the region hopes and, particularly, incentives to think less about the past and more about a better future;
- there is need for considerable and creative aid (from outside), in the vein of a Grand Plan. If a new Marshall Plan did not come into being in the aftermath of the fall of the Berlin Wall, working out a plan now for this region is almost a must. Actually, seeds of such a grand scheme exist already: The Stability Pact, the South Eastern European Initiative (SECI), the Central European Initiative. But these seeds need to be fused into a single grand plan for the sake of focusing energy, providing effective leadership, and using resources better. With Romani Prodi at the helm of the EU, certainly, Brussels will become much more sensitive to the plight of the region.
- Bulgaria and Romania should be covered by such a plan. Both countries can operate as in-built political stabilizers, but are themselves in need of economic support.
- The Plan should consider more forceful measures for dealing with various social and institutional evils which plague the region ( drug-trafficking, arms-smuggling, etc). This would be also part of the long-term exercise in crisis-management (confidence-building).

## 5. Final remarks

We were, in the East, especially in the early 90s, quite oblivious to the fact that Western Europe itself was going through hard times. That there, there is need for reforming the welfare state, for more flexibility, for regaining vitality in a world subjected to the growing pressures of globalisation, of competition. Even the introduction of the Euro is read by some as a “weapon”, whether it is declared publicly or not. It’s about competition in the world. And it’s not clear what is going to happen in the period to come because the European Union has to deal with its own structural problems.

Ironically, the euphoria following the collapse of the Berlin Wall met with Euro-scepticism in the West. Although, one has to admit, that bouts of Euro-scepticism have been recurrent along the path of European integration. Let’s remember, for instance, the late sixties which were pertinently illustrated, as a political mood, by J.J. Servan Schreiber’s book, “Le Defi Americain” (The American Challenge); or later, during the 80s, the fear of Japan Inc. and the Asian Tigers.

Another irony is that whereas, at the beginning of transition, in Central and Eastern Europe some aired the idea of a ‘dritter Weg’ (remember Zdenek Mlynar), which was, on justified grounds, rejected by most politicians, nowadays, many social-democratic governments in the



West are searching for a “Third Way”; where the latter is meant to preserve perceived advantages of the “Continental model” and help deal with the impact of globalisation and information technologies. Would this search influence Enlargement? What is certain is that, in most post-communist countries, much of the fundamentals of market based systems is quite fragile and a lot of work still needs to be done.

The increasing reluctance of western Europeans to accept quick admissions into the EU, or a defined calendar, is a reflection of the growing discrepancy between the rhetoric of Enlargement and what happens in reality, under the spell of pragmatic considerations. For policy-makers calculate costs and benefits, and they need hard data to this end; it goes without saying that they have a very difficult time in incorporating the soft variables of Enlargement, such as the costs of non-enlargement. Therefore, the conclusions and decisions they reach are skewed by leaving aside what is not clear, or hard to estimate, like political or geopolitical consequences of integration, which, over the longer term do have an economic impact. To all this conundrum one has to add the Balkans quagmire, which mirrors ghosts of the past and the present, and, also, the inability of Europeans to identify a way out at the very moment of trying to achieve a united Europe.

Europe needs to be embedded into the dynamics of the world. And, in this respect, I wish to highlight the growing complexity of the world, of the world economy? I stress the notion of complexity for, I think, there is here a psychological and a cognitive problem. We, probably, got used to a certain type of stability, which was couched in the structures of the bipolar world and of a simple ideological confrontation, but also in the sort of an apparent linearity of technological progress. We live in a different environment nowadays; the trend towards a multipolar world, the new information technologies which enhance globalisation, the clash between integration and fragmentation, the sometimes violent instances of “clash of civilisations” (to use Samuel Huntington’s famous sintagma) etc. These phenomena are something which, we have a difficulty in digesting analytically and responding operationally. In this context one has to mention the globalisation of financial markets and the ensuing very severe financial crisis which has engulfed many emerging markets, in East Asia, Russia and elsewhere. But I would recall that previous signs of the financial “El Nino” were delivered by the Mexican crisis in late 1994 and, quite revealingly, by the turbulence around the Exchange Rate Mechanism during 1992-1993.

Many astute watchers and professional heavyweights are stunned by the rapidity of events and the spread of turmoil. From “irrational exuberance” to “irrational stampede out” is a way to illustrate the functioning of large scale volatile capital, which leaves many unanswered questions and befuddles policy-makers. More dismayingly, it can lead to social and economic dislocations which, through their proportions, are reminiscent of the Great Depression. Think about the plight of tens of millions of people in Indonesia and elsewhere. Or a few years earlier, in Mexico, after the dramatic fall of the Peso. This is why we need to worry about, formulate the right questions (about what went wrong) and try to find right policy responses.

There is need for more humility when approaching this state of affairs, including more intellectual self-scrutiny and honesty in dialogue, as there is need for more genuine leadership in policy-making. Some are saying that there is a leadership vacuum, and that this explains why political solutions are not ready at hand. But this vacuum was mentioned by the London based International Institute for Strategic Studies in the early 90s, much ahead of the current world financial crisis. This would indicate leadership shortage as a sign of the troubles governments encounter in our changing world, the difficulties they have in understanding and managing change.

Joining the European Union, to a large extent, overlaps with what post-communist countries have to do, under any circumstances, in order to create market based economies and democratic

polities, or what Karl Popper named open societies; which means, irrespective of whether a post-communist country decides to join the EU or not. Creating open societies is a much more complex and complicated process than what is assumed by price liberalisation, privatisation, and economic opening. These headline words cannot capture the nature of institutional and cultural change, the strain in the systems plagued by terrible resource misallocation. This is why, unless buttressed by change in the real economy and the functioning of institutions, macroeconomic stabilisation is only temporary and numbers can be very misleading. Four years ago Albania was hailed as a miracle, with 4% annual inflation rate. 7, 8 months ago Russia was having an annual inflation rate of cca. 10%. And we all saw what occurred, against the background of institutional disarray and hardly sustainable policies. It has always been my opinion that insufficient attention has been paid, theoretically, and policy-wise, to the magnitude of required resource reallocation in the post-communist countries. Likewise, it is my view that institutional change is what matters in the end, and that, here, one cannot practice hocus-pocus (voodoo) economics; even restructuring hinges on the way institutions do performs.

Let me emphasise a thesis which, I hope, will find a sympathetic hearing. Aside from policy consistency and a sense of direction, the countries which have scored better results have done it owing to better preconditions (the legacy of the past including histories of partial reforms) and the geographic proximity to the EU. Isn't it striking the existence of a cluster of "front runners" in the close vicinity of the EU? Investments, foreign capital, which poured into those countries were attracted by policies pursued by government. But clearly there was also a set of initial circumstances which favoured good results. What I am concerned about is that for most of the lagging countries, for those at the periphery of Europe, a bad path-dependency has been developing, which will clobber them for a long period of time. The former ideological and political divide, which existed in the pre-1989 Europe, is being replaced by new divides, which have essentially an economic dimension. Unless clever decisions are undertaken by political leaders the unification of Europe, in the sense of "economic inclusion" –to use a term much en vogue among the politicians of Europe--of most of the post-communist countries, will remain a very distant goal. To this unfolding one has to consider the implications of a feeling among the citizens in the lagging countries that they do not belong, actually, to the clubs of Europe, to the relevant institutional Europe, which may only accentuate disappointments and identity crises.

In order to overcome such a new "great divide" vision needs to be accompanied by a strategy which should combine much more commitment by Brussels (by the EU governments) with the in-house reform efforts of the candidate countries. The EU governments have to labour on three fronts: at home; the reform of the EU (the common agricultural policy, regional development, etc); and the international dialogue which deals, inter alia, with the world-wide financial crisis. All these fronts do have, directly or indirectly, an impact on Enlargement.

Governments in Central and Eastern Europe have to persist in structural reforms (deep restructuring), in building up institutions, in strengthening financial systems. I emphasise the need to nurture the development of a strong middle class, a solid civil society, as the backbone of well functioning market economies and democracies. Where citizens do not feel empowered economically and politically friction is unavoidable and energies do not translate into steadily higher overall economic performance. This is why it makes sense to think about the variety of capitalism in the making in the post-communist world, in Europe. Trying to answer such a question has relevance for the issue of Enlargement as well.

The dialogue about Enlargement poses a major question from the perspective of the political economy of the process. How can people in the West get a level of comfort with this process, which should facilitate it? Because, ultimately, it is not Brussels which will decide on the speed, the pace of admission, but national governments --governments which are accountable to their electorates. If western citizens won't feel comfortable with admission, if they will think that this

is going to increase structural employment, politically articulated interests will not retard to reflect those anxieties. And this politically articulated opposition is likely to cause a delayed process of admission. I am not one of those who are asking for a very quick admission, irrespective of costs, on both sides. I am in favour of realism, of an enlightened pragmatism, which should acknowledge the various constraints for rapid Enlargement, but also caution against losing sight of the target and the momentum. We all have a stake in it, in forging a true partnership at work.

As I wish to emphasise again, European dynamics cannot be divorced of developments in the world economy. There is so much turmoil there that many knowledgeable people are asking for a revision of the architecture of the international economic system, which should replace the Bretton Woods structures. Whatever will come out of the current endeavours, it is clear that the international system will have to face the increased vulnerability of those who are less capable to weather external shocks. And here there is a joint paradox and irony. Those who are more likely to be forced to brace themselves for dealing with the volatility of large capital movements, are less capable to do it because they have fragile institutions and structures; because solid institutions cannot be created overnight.

On a more general plane, if the world economy won't have the kind of dynamic which would prevent the EU from turning more protectionist, from becoming an insulated fortress which would divert trade (in a world of "trading blocs"), a speedier and smooth admission would be hard to take place.

**Table 1**

**Basic data, 1998**

	Gross domestic product								
	Popu- lation (m)	Per head <sup>b</sup> (\$)	Per head <sup>c</sup> (\$)	Index 1989=100	Growth (av;%) 1994-98	Inflation (av;%) 1994-98	Exports (\$bn)	Imports (\$bn)	Current account (\$bn)
<b>East-central Europe</b>	<b>66.4</b>	<b>7,848</b>	<b>4,421</b>	<b>106.4</b>	<b>4.6</b>	<b>14.4</b>	<b>96.99</b>	<b>118.48</b>	<b>-12.27</b>
Hungary	10.1	7,865	4,709	95.4	3.1	20.5	20.75	22.87	-2.30
Poland	38.7	6,892	3,879	117.3	6.0	21.3	30.12	43.84	-6.86
Czech Republic	10.3	10,392	5,413	95.4	2.3	9.4	26.36	28.94	-1.05
Slovakia	5.4	8,123	3,878	99.8	5.9	8.4	10.67	12.96	-2.06
Slovenia	2.0	12,442	9,814	104.1	4.3	12.0	9.10	9.87	-0.00
<b>Balkans</b>	<b>55.6</b>	<b>3,916</b>	<b>1,676</b>	<b>68.9</b>	<b>1.2</b>	<b>71.1</b>	<b>21.60</b>	<b>31.73</b>	<b>-6.80</b>
Albania	3.8	1,433	783	86.0	5.5	19.1	0.22	0.86	-0.42
Bulgaria	8.3	4,404	1,486	65.7	-1.9	152.5	4.29	4.61	-0.25
Croatia	4.6	6,402	4,663	78.1	5.6	18.0	4.60	8.77	-1.55
Macedonia	2.0	2,915	1,773	71.9	0.4	22.7	1.32	1.72	-0.29
Romania	22.5	4,126	1,785	76.4	0.0	77.5	8.30	10.91	-3.01
Yugoslavia	10.6	3,100	1,206	50.4	4.4	38.9	2.86	4.85	-1.28

<b>Baltics</b>	<b>7.6</b>	<b>4,563</b>	<b>2,947</b>	<b>66.1</b>	<b>2.9</b>	<b>23.3</b>	<b>8.55</b>	<b>12.31</b>	<b>-2.47</b>
Estonia	1.5	5,490	3,660	80.5	4.7	23.6	2.68	3.80	-0.45
Latvia	2.5	4,138	2,612	59.3	3.0	18.1	1.90	3.03	-0.71
Lithuania	3.7	4,480	2,888	65.0	1.9	27.9	3.96	5.48	-1.31
<b>CIS</b>	<b>283.2</b>	<b>3,182</b>	<b>1,362</b>	<b>56.1</b>	<b>-5.2</b>	<b>242.0</b>	<b>107.85</b>	<b>99.32</b>	<b>-5.67</b>
Russia	146.5	4,141	1,888	55.8	-4.9	92.1	74.75	57.45	2.45
Ukraine	50.1	2,143	846	49.9	-10.3	155.6	13.70	16.28	-1.30
Belarus	10.2	4,554	1,394	74.7	-0.7	280.5	7.08	8.53	-0.94
Moldova	4.3	1,515	380	32.6	-10.4	62.5	0.64	1.04	-0.33
Armenia	3.9	2,508	483	57.3	5.7	190.1	0.23	0.81	-0.41
Azerbaijan	7.6	1,172	538	42.7	-3.9	103.4	0.68	1.72	-1.36
Georgia	5.4	1,353	897	30.1	0.2	263.8	0.19	1.05	-0.72
Kazakhstan	15.5	2,721	1,434	61.8	-4.6	149.0	5.76	6.76	-1.43
Kyrgyz Republic	4.7	1,584	347	59.6	-2.2	55.8	0.54	0.71	-0.29
Tajikistan	6.1	710	216	40.7	-6.8	241.9	0.60	0.77	-0.22
Turkmenistan	4.7	1,088	562	44.3	-11.7	444.6	0.59	0.98	-0.64
Uzbekistan	24.0	2,031	508	89.0	0.1	186.9	3.08	3.21	-0.48
<b>Eastern Europe</b>	<b>122.0</b>	<b>5,935</b>	<b>3,171</b>	<b>92.3</b>	<b>3.6</b>	<b>46.6</b>	<b>118.59</b>	<b>150.21</b>	<b>-19.07</b>
<b>Eastern Europe and the former Soviet Union</b>	<b>412.8</b>	<b>4,021</b>	<b>1,926</b>	<b>67.9</b>	<b>-1.8</b>	<b>167.0</b>	<b>234.98</b>	<b>261.84</b>	<b>-27.21</b>

<sup>b</sup>At purchasing power parities; <sup>c</sup>At market exchange rates.

Sources: National statistics; EIU estimates.

**Table 2 : Comparative Study of Government Revenues (Total Revenue) for Selected Eastern European Countries, 1990-1997**

In percent of GDP

	1990	1991	1992	1993	1994	1995	1996
<b>ROMANIA</b>	39.7	41.9	37.4	33.9	32.1	31.9	29.6
<b>ALBANIA</b>	46.8	31.5	23.5	25.6	24.5	24.0	...
<b>BULGARIA</b>	52.9	40.4	38.4	37.2	39.9	36.2	33.6
<b>CZECH REPUBLIC</b>	...	...	48.2	50.5	49.4	48.4	...
<b>HUNGARY</b>	52.1	50.9	50.0	50.7	49.6	46.6	45.8
<b>POLAND</b>	45.4	42.4	43.9	47.6	47.2	47.2	45.7
<b>SLOVAK REPUBLIC</b>	...	...	46.1	44.2	46.3	46.8	...

Sources: Country authorities; and IMF estimates.

**Table 3: Income per capita in several European countries**

(in US dollars)

	1993*
Albania	999
Romania	2,806
Lithuania	3,110

Bulgaria	4,100
Poland	5,010
Hungary	6,050
Slovak Republic	6,290
Estonia	6,320
Czech Republic	7,541
Greece	8,429
Portugal	9,982
Spain	13,110
European Union average	17,288

\* for the post-communist countries the income is calculated on a PPP (purchasing power parity) basis, which means that the figures are higher than the official ones. It can be said that, in general, the figures for the economies in transition have to be looked at with caution, especially when the various sources vary considerably in their estimates.

Sources: Transition Report, EBRD, October 1994, p.7; The European Union Survey, *The Economist*, 22 October 1994, p.4

**Table 4: Monthly wages in several post-communist countries (US dollars/month)**

	<b>1997*</b>
Slovenia	421
Hungary	308
Czech Republic	332
Slovak Republic	283
Poland	320
Bulgaria	82
Latvia	219
Estonia	257
Romania	87
Lithuania	207
Ukraine	82

\* Gross average monthly wages per employee in manufacturing

*Sources:* IMF data quoted by Transition Report, EBRD, 1998, p.66

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